PsiNaptic

2004 ANNUAL REPORT

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PsiNaptic is a technology company that develops and markets middleware software based on open standards to address the growing need to connect small, low-power wired or wireless devices without human intervention, configuration or set up.

Our Company is driven by the need to reduce complexity in computing networking, and to improve the human experience regarding data consumption in a mobile world. Our vision of the world is one in which billions of small embedded devices, all offering services and information, are connected to a network – a world where mobile devices such as cell phones and PDAs communicate with these and other devices to consume services and information with minimum human intervention. Management believes that PsiNaptic's technology and products play an important role in enabling this seamless communication between mobile and embedded devices.

PsiNaptic solutions operate on multiple platforms, across various networks and in all environments. With PsiNaptic's small-footprint adaptive networking technologies, networks of intelligent objects – from servers to embedded processors and Bluetooth® chips – can dynamically exchange information and services where and when needed, on a single protocol, independent of how the underlying hardware or software is configured and/or managed.

Corporate Timeline

January 2000	PsiNaptic is founded in Calgary, Alberta, Canada
November 20, 2001	PsiNaptic launches its first product - JMatos® software for embedded devices - after clearing Sun Microsystems' tests
September 2, 2002	PsiNaptic launches CMatos, extending JMatos Jini technology capabilities to non-Java devices
June 17, 2003	Ford Motor Co. and PsiNaptic collaborate to bring Jini networking technology capabilities to the automotive industry
January 21, 2004	PsiNaptic completes its initial public offering

Letter to the Shareholders

We are pleased to present this report - our first as a public company.

This year saw renewed interest in research and development of wireless capabilities on the part of many manufacturers and suppliers. Accordingly, PsiNaptic vigorously pursued the milestones set out in our prospectus of January 6, 2004 and, while we were unable to successfully complete all the milestones, we continue to be committed to our vision.

PsiNaptic was able to complete the integration of JMatos with the Sony Ericsson P800 Bluetooth-enabled cellular telephone. In addition, work has commenced on the integration of our product onto a second Bluetooth-enabled cellular phone from one of the world's leading cellular phone manufacturers. The integration of JMatos with cellular phones is key to the enabling of our vision and will allow value-added communication applications to be developed in the future.

PsiNaptic completed the integration of CMatos with the CSR BlueCore2 Bluetooth chip manufactured by Cambridge Silicon Radio (U.K.). While we have yet to sign a formal co-marketing agreement with CSR, we continue to work closely with them to advance our joint solution. CSR promoted our product at the Wireless Connectivity World conference in Amsterdam in June 2004 and at the Wireless Connectivity Americas conference in Santa Clara in November 2004.

We continue to work with Dallas Semiconductor Inc., a major designer, manufacturer, and marketer of mixed-signal, specialty semi-conductors, towards a formal partnership agreement.

We were unable to gain the necessary support from a vending machine supplier for the development of a "proof of concept" presentation to a major soft drink company. The concept of communication between parking meters and automobiles and/or cell phones was not completed in this fiscal year. Nevertheless, work with our partners on these projects continues and we feel these remain viable opportunities.

While we were unable to generate revenue from services to be provided by our engineers to a major automobile manufacturer, our dialogue with the manufacturer continues. Indeed, the acceptance of our presentation of our joint work with the Ford Research Group at the JavaOne Conference in San Francisco in June 2004 gives us further confidence that our development project will yield results in the near future.

The success of PsiNaptic is dependent on the demand for simplicity created by a society which is embracing technology at an ever increasing rate. We continue to believe that PsiNaptic's technology and products will play an important role in enabling this seamless communication between mobile and embedded devices.

Sincerely,

A. Dagan

Aaron Dagan
President and Chief Executive Officer
December 22, 2004

Management's Discussion and Analysis

Prepared as of December 22, 2004.

HIGHLIGHTS FOR THE 2004 FISCAL YEAR

Financial Highlights

For the Years ended September 30	2004	2003
Revenue	**$ –**	$ –
Net earnings (loss)	**$ (774,877)**	$ (55,359)
per share – basic	**$ (0.0451)**	$ (0.0046)
Cash flow from operations	**$ (736,344)**	$ 54,631
Working capital	**$ 401,629**	$ 147,633
Total assets	**$ 496,408**	$ 333,625
Capital expenditures	**$ 4,498**	$ 959
Long-term debt	**$ –**	$ –
Shareholders' equity	**$ 459,849**	$ 290,633
Weighted average shares outstanding		
basic	**17,166,964**	12,069,535
Shares outstanding at period end	**18,906,812**	13,049,809

Operating Highlights

January 21, 2004 – PsiNaptic completes its initial public offering

February 9, 2004 – PsiNaptic announces the integration of CMatos with the Dallas Semiconductor TINI platform

May 12, 2004 – PsiNaptic announces its first licensing agreement

June 9, 2004 – PsiNaptic integrates CMatos with CSR BlueCore2, Bluetooth chip

August 9, 2004 – PsiNaptic announces its second licensing agreement

Operations Review

INTRODUCTION

PsiNaptic believes that the next wave of communications, often referred to as machine-to-machine communications, is now beginning. Machines - not just computers, but phones, automobiles, clothing, appliances, jewelry, sensors, controllers and many other devices - will be able to interact with each other and complete tasks on behalf of the users of those machines.

Such an environment, where machines will access the information and services of other machines, is a "pervasive computing environment." The core of this environment comprises computers and servers wired together in a series of networks which are in turn connected via the existing telecommunications infrastructure. The edges of this environment consist of wireless devices such as cell phones and PDAs.

"Embedded processors" or "embedded systems" are specialized computers or self-contained systems, often hidden from the end user, found in automobiles, home and office appliances and hand-held units of all kinds.

The market space in which PsiNaptic is focusing its efforts is the overlap between the pervasive computing market and the embedded systems market.

The Company focuses on the devices at the edge of the network and enables them to communicate and access one another. This is done in a manner that is seamless, that does not require pre-programming to deal with other devices, and that requires minimal, if any, human intervention at the time of the communication to facilitate it.

The key to PsiNaptic's vision is the use of standard computing and communications protocols to ensure interoperability between the devices. By employing high-level distributed computing protocols, these objects can communicate with and accept information and services from each other.

TECHNOLOGIES

In the development of its technology, PsiNaptic has focused on the near-term convergence of several key technologies in the "pervasive computing" space:

- JAVA

  Java™ is defined as "a simple, object-oriented, network-savvy, interpreted, robust, secure, architecture-neutral, portable, high-performance, multithreaded, dynamic language." It is compiled into a standard byte code which makes it possible to write an application and have that application run on any platform that has implemented a Java Virtual Machine. This makes Java "architecture-neutral" and provides a means of exchanging code, along with data, between platforms.

- JINI

  Jini network technology enables devices to seamlessly access each other, seek out and exchange applications and information, and adapt to a continually changing environment. Until recently, Jini technology's large footprint (3MB) made it impractical for many embedded Java devices.

  Through Java and Jini, it is possible to use a 'service-centric' architecture to allow effective use of the services available on a network. As long as the service interface is defined, the details of the service implementation can change as you buy new equipment and as equipment or technologies change.

- BLUETOOTH

  Bluetooth wireless communications technology is a de facto standard as well as a specification for small-form factor, low cost, short-range radio links between mobile PCs, mobile phones and other portable devices. It enables wireless connectivity to networks and other devices any time, anywhere, and makes low-cost, low-power wireless networking a reality for all types of resource-constrained devices.

PSINAPTIC PRODUCTS

- JMatos®

  JMatos is an implementation of the Jini Lookup Service and related protocols that enables very small-embedded processors to offer Java based services. Fully Jini Network Technology compliant, Jmatos' less than 100KB footprint enables resource-constrained devices to find each other and spontaneously offer or consume services on a network.

  JMatos extends Jini Network functionality to devices on the edge of the net, making possible an end-to-end pervasive computing solution, based on an open standard protocol.

- CMatos

  Fully Jini Network Technology compliant, Cmatos' less than 60KB footprint lookup and discovery protocol enables resource constrained devices to find each other, interconnect and spontaneously offer or consume services on a network or any computing device that acts as a Jini client.

  CMatos extends the reach of Java into non-Java devices and enables legacy devices to become Jini network capable. CMatos is available in even smaller footprints for devices that do not need to register external services.

PSINAPTIC MARKETPLACE

Management continues to focus its marketing efforts on the three vertical markets in which it has gained traction to date – Cellular Phones, PDAs and Handheld Computers; Home Automation and Automotive Telematics.

The research department of a mobile phone manufacturer has requested PsiNaptic to integrate its software onto one of their existing models. Management believes it can capitalize on this project and, if successful, expects it to lead to the integration of its software onto futuristic smart phones.

A major supplier of entertainment technology to the auto industry has expressed an interest in our technology and we continue to further our discussions with Ford Motor Company.

The existing licensing agreements with companies based in Singapore and California and interest from companies in Europe endorse Management's belief in the worldwide appeal of its software.

The fourth market - Healthcare and medical record automation – is still considered a viable opportunity but is not expected to be responsive to a marketing effort in the near term.

Financial Statement Discussion and Analysis

This discussion and analysis should be read in conjunction with the audited financial statements of PsiNaptic Inc. ("PsiNaptic" or "the Company") as of September 30, 2004. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP").

FORWARD – LOOKING STATEMENTS

The MD&A contains forward-looking statements, including the Company's expectations as to the success of its research and development programs related to JMatos® and CMatos, which involve known and unknown risks and uncertainties, which could cause the Company's actual results to differ materially from those in the forward-looking statements. Such risks and uncertainties include, among others, the availability of funds and resources to successfully commercialize JMatos® and CMatos and general changes to the economic environment. Investors are cautioned against placing undue reliance on forward-looking statements. The Company does not undertake to update these forward-looking statements.

Comparison of the years ended September 30, 2004 and 2003

HIGHLIGHTS

The Company announced its first licensing agreement in the third quarter with Majitek International (headquartered in Singapore), a company that develops software tools for smart embedded systems used in industrial automation, home automation and home digital media delivery.

Also in the third quarter, PsiNaptic signed a licensing agreement with Modius Inc. (headquartered in Pleasanton, Ca. USA), a company which integrates the monitoring and management of machinery information for industrial automation.

RESULTS OF OPERATIONS

PsiNaptic incurred an operating loss of $854,685 in the year ended September 30, 2004, which compares to an operating loss of $373,174 in the year ended September 30, 2003. The net loss, after expense recoveries and interest, was $774,877 for the year ended September 30, 2004 compared to net loss of $55,359 for the year ended September 30, 2003.

OPERATING EXPENSES

Total operating expenses increased to $854,685 in the year ended September 30, 2004 from $373,174 in the year ended September 30, 2003. Salaries, including consultants, and benefits were $566,766 in the year ended September 30, 2004 compared to $182,373 in the year ended September 30, 2003. This increase reflects the addition of personnel and recommencement of salaries in the second fiscal quarter. Other general and administrative costs increased to $165,444 in the year ended September 30, 2004 from $128,727 in the year ended September 30, 2003. This increase reflects the additional costs involved as a public company.

Other marketing expenses increased to $74,323 in the year ended September 30, 2004 from $16,724 in the year ended September 30, 2003, reflecting increased marketing research, travel and promotion.

RECOVERIES AND OTHER INCOME

PsiNaptic earned net interest income of $9,862 in the year ended September 30, 2004 compared to $4,636 in the year ended September 30, 2003.

The Company recorded an IRAP grant of $58,397 earned in the year ended September 30, 2004, an increase from $15,300 earned in the year ended September 30, 2003. This project was completed in the fourth quarter of fiscal 2004.

For the year ended September 30, 2004 the Company recorded $11,549 on account of an SR&ED claim, a decrease from $297,879 during the year ended September 30, 2003. This reflects the reduced level of research activity during fiscal 2003 as compared to fiscal 2002.

FINANCIAL CONDITION AND LIQUIDITY

Funds used in operations were $736,344 in the year ended September 30, 2004, compared to $54,631 generated in the year ended September 30, 2003. This further reflects the shift to a period of greater operating expenses with little contribution from an SR&ED claim in fiscal 2004 from a period of cost containment and receipt of the large SR&ED claim in fiscal 2003.

Financing activities during the year ended September 30, 2004 resulted in gross proceeds of $1,300,000 of which $1,250,000 was received from the initial public offering (IPO) of 5 million Class A common shares at $0.25 each. Net proceeds of the IPO, after financing costs of $356,266 were $893,734. In the year ended September 30, 2003 the Company received and repaid $74,419 of shareholders' loans.

Investing activities during the year ended September 30, 2004 consisted of the investment of funds from the proceeds of the IPO in excess of its immediate needs.

Also during the year ended September 30, 2004, the Company expended $3,326 related to the protection of its intellectual property, compared to $6,489 in the year ended September 30, 2003.

Comparison of the three months ended September 30, 2004 and 2003

HIGHLIGHTS

During the fiscal fourth quarter, the Company progressed in integrating its products with those of its customers under its licensing agreements executed in the third fiscal quarter.

RESULTS OF OPERATIONS

PsiNaptic incurred an operating loss of $221,403 in the quarter ended September 30, 2004, which compares to an operating loss of $110,602 in the quarter ended September 30, 2003. The net loss, after expense recoveries and interest, was $216,879 for the quarter ended September 30, 2004 compared to net loss of $94,970 for the quarter ended September 30, 2003.

OPERATING EXPENSES

Total operating expenses increased to $221,403 in the quarter ended September 30, 2004 from $110,602 in the quarter ended September 30, 2003. Salaries, including consultants, and benefits were $142,943 in the quarter ended September 30, 2004 compared to $55,643 in the quarter ended September 30, 2003. This increase reflects an increase in the staff complement and the resumption by the Company of paying salaries. Other general and administrative costs increased to $52,912 in the quarter ended September 30, 2004 from $33,863 in the quarter ended September 30, 2003, primarily due to costs of investor relations and accrued audit costs.

Due to increased travel expenses, other marketing expenses increased to $17,589 in the quarter ended September 30, 2004 from $9,071 in the quarter ended September 30, 2003.

RECOVERIES AND OTHER INCOME

PsiNaptic earned net interest income of $2,165 in the quarter ended September 30, 2004 compared to $332 in the quarter ended September 30, 2003.

The Company recorded an IRAP grant of $2,359 earned in the quarter ended September 30, 2004 compared to $15,300 in the quarter ended September 30, 2003. This contract commenced in July 2003 and was completed in July 2004.

FINANCIAL CONDITION AND LIQUIDITY

Funds used in operations were $183,233 in the quarter ended September 30, 2004, compared to $33,584 in the quarter ended September 30, 2003.

Investing activities during the quarter ended September 30, 2004 consisted of the redemption of funds originally invested from the proceeds of the IPO in excess of its immediate needs.

During the three months ended September 30, 2003, the Company issued 600,000 shares for proceeds of $150,000 and recorded deferred financing costs of $60,000 related to the IPO which closed in January 2004.

Since PsiNaptic's inception, the Company has not engaged in any off-balance sheet financial arrangements, nor in any financial instruments and other instruments which might be settled by delivery of non-financial assets.

During the period November 2002 to May 2003, the Company received advances from shareholders who might have been considered related parties at that time. In May 2003, all such advances were repaid. Since then, the Company has not engaged in any transactions with related parties.

HISTORICAL INFORMATION

		Total Assets		Net Loss (Income)		Loss (Income) Per Share
Year ended September 30, 2002	$	160,593	$	1,197,281	$	0.0994
Quarters ended:						
December 31, 2002			$	91,727	$	0.0076
March 31, 2003			$	93,912	$	0.0078
June 30, 2003			$	(225,250)	$	(0.0187)
September 30, 2003			$	94,970	$	0.0073
Year ended, September 30, 2003	$	333,625	$	55,359	$	0.0046
Quarters ended:						
December 31, 2003			$	144,542	$	0.0109
March 31, 2004			$	211,401	$	0.0120
June 30, 2004			$	202,055	$	0.0107
September 30, 2004			$	216,879	$	0.0115
Year ended September 31, 2004	$	496,408	$	774,877	$	0.0451

In general, calendar 2003 reflects a period of cost containment and reduced overhead expense. In the quarter ended June 30, 2003, the Company recorded $297,879 on account of SR&ED expenditures during fiscal 2002.

Commencing in January 2004, the Company expanded its human resources, commenced paying salaries closer to market value for those resources, and increased its marketing effort.

LIQUIDITY AND CAPITAL RESOURCES

As a result of the successful closing of the IPO on January 21, 2004, the Company was able to operate within its forecasted cash requirements throughout the year and ended its 2004 fiscal year with working capital of $401,629. PsiNaptic is taking steps to reduce its expenses and maximize the use of its available funds.

Whereas the Company had expected its licensing agreements to generate modest licensing fees to be recorded in the fourth quarter of fiscal 2004, the integration of its products into the bundled products was not completed as anticipated and the resulting royalty recognition will now be postponed to the first fiscal quarter of 2005. Thereafter, the revenues generated are dependent on the volume of bundled products delivered by the Company's partners to their customers. At this time, the Company is unable to reliably quantify such volume.

Until PsiNaptic is able to achieve substantial revenues or profitability over several quarters, the Company remains dependent on financing resources for cash flows to meet operating expenses. The Company is presently investigating both public and private sources of funds. PsiNaptic cannot offer assurance of our financial success or economic survival.

CHANGE IN ACCOUNTING POLICY INFORMATION

On October 1, 2003, the Company adopted the new accounting standards, which establish the standards for recognition, measurement and disclosure of the impairment of long-lived assets. The standards require that long-lived assets be tested for recoverability whenever events or circumstances indicate that carrying value may not be recoverable. No impairment loss has been recognized in the statement of loss for the year ended September 30, 2004.

On October 1, 2003, the Company elected to prospectively adopt the fair value based method of accounting for options granted subsequent to October 1, 2003 under its stock-based compensation plan as recommended by the Canadian Institute of Chartered Accountants ("CICA"). Compensation expense of $359 has been recognized in the statement of loss for the year ended September 30, 2004 using the fair value based method as described in Note 7. Previously, the Company accounted for its stock-based compensation plan using the intrinsic value based method and accordingly, did not recognize compensation expense in the financial statements for share options granted to employees and directors when issued at market value.

The Company's stock-based compensation plan is described in Note 7.

On September 7, 2004, The Company adopted a Revenue Recognition Policy in anticipation of recognizing revenue from its reseller agreements executed in the second fiscal quarter. The agreements typically call for the reseller to pay a royalty fee for our software and a royalty fee based on the related number of units/users. We will recognize revenue associated with these agreements when we have met our revenue recognition criteria for license agreements as outlined in Note 4.

ADDITIONAL INFORMATION

Additional information relating to PsiNaptic can be located on SEDAR at **www.sedar.com**.

Management's Responsibility for the Financial Statements

The accompanying audited financial statements and all of the information included in this annual report have been prepared by and are the responsibility of management and have been recommended by the audit committee for approval by the Board of Directors. The annual financial statements have been prepared in accordance with generally accepted accounting principles and reflect management's best estimates and judgements based on current information. The significant accounting policies which management believes are appropriate for the Company are described in Note 4 of the annual financial statements.

The Company has developed and maintains an appropriate system for internal controls in order to ensure, on a reasonable and cost-effective basis, that relevant and reliable financial information is produced.

The Audit Committee is appointed by the Board and consists of two independent Directors and the President. To discharge its duties the Audit Committee meets regularly with management and Deloitte & Touche LLP to discuss internal controls, accounting and financial reporting processes, audit plans and financial matters.

Deloitte & Touche LLP is responsible for auditing the financial statements and expressing their opinion thereon and their report is presented separately. The external auditors have full and free access to meet with management, the Audit Committee and the independent members thereof.

A. Dagan

Aaron Dagan
President and Chief Executive Officer
December 22, 2004

Morris Bleviss

Morris Bleviss
Chief Financial Officer

Auditors' Report

To the Shareholders of
PsiNaptic Inc.:

We have audited the balance sheets of PsiNaptic Inc. as at September 30, 2004 and 2003 and the statements of loss and deficit and cash flows for the years ended September 30, 2004 and 2003 and cumulative from inception on December 16, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2004 and 2003 and the results of its operations and its cash flows for the years ended September 30, 2004 and 2003 and cumulative from inception on December 16, 1999 in accordance with Canadian generally accepted accounting principles.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP — Chartered Accountants
Calgary, Alberta — October 22, 2004

Statements of Loss and Deficit

Years Ended September 30, 2004 and 2003 and Cumulative From Inception on December 16, 1999

	September 30, 2004	September 30, 2003	Cumulative From Inception on December 16, 1999
EXPENSES			
Depreciation and amortization	**$ 32,605**	$ 38,836	$ 229,598
General and administrative	**347,521**	168,867	1,353,114
Marketing	**262,171**	110,664	1,101,466
Research and engineering	**212,388**	54,807	1,860,669
	854,685	373,174	4,544,847
LOSS BEFORE OTHER INCOME	**(854,685)**	(373,174)	(4,544,847)
OTHER INCOME			
IRAP expense recovery	**58,397**	15,300	211,197
Interest income	**9,862**	4,636	101,998
Consulting revenue	**–**	–	18,405
SRED tax credits	**11,549**	297,879	620,152
	79,808	317,815	951,752
NET LOSS	**(774,877)**	(55,359)	(3,593,095)
DEFICIT, BEGINNING OF YEAR	**(2,818,218)**	(2,762,859)	–
DEFICIT, END OF YEAR	**(3,593,095)**	(2,818,218)	(3,593,095)
LOSS PER SHARE (Note 11)	**(0.0451)**	(0.0046)	–

Balance Sheets

As at September 30, 2004 and 2003

	2004	2003
ASSETS		
CURRENT		
Cash	**$ 22,208**	$ 161,310
Short-term investments	**398,668**	–
Accounts receivable	**4,127**	20,215
Prepaid expenses	**13,185**	9,100
	438,188	190,625
Deferred financing costs	**–**	60,000
Capital assets (Note 5)	**37,868**	47,455
Intellectual property (Note 6)	**20,352**	35,545
	496,408	333,625
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	**36,559**	42,992
SHAREHOLDERS' EQUITY		
Share capital (Note 7)	**4,052,944**	3,108,851
Deficit	**(3,593,095)**	(2,818,218)
	459,849	290,633
	496,408	333,625

APPROVED BY THE BOARD

'SIGNED'

Andrew L.Oppenheim
Director

'SIGNED'

Stuart M.Olley
Director

Statements of Cash Flows

Years Ended September 30, 2004 and 2003

	September 30, 2004	September 30, 2003	Cumulative From Inception on December 16, 1999
OPERATING			
Net Loss	**$ (774,877)**	$ (55,359)	$ (3,593,095)
Adjustments for:			
Depreciation and amortization	**32,605**	38,836	229,598
Non-cash marketing expense	**–**	100,000	100,000
Stock-based compensation	**359**	–	359
	(741,913)	83,477	(3,263,138)
Changes in non-cash working capital:			
Accounts receivable	**16,088**	(15,345)	(4,127)
Prepaid expenses	**(4,085)**	8,108	(13,185)
Accounts payable and accrued liabilities	**(6,434)**	(21,609)	36,559
	(736,344)	54,631	(3,243,891)
INVESTING			
(Purchase) redemption of short-term investments	**(398,668)**	10,072	(398,667)
Purchase of capital assets	**(4,498)**	(959)	(233,198)
Protection of intellectual property	**(3,326)**	(6,489)	(73,139)
SRED recovery on capital assets	**–**	2,756	18,518
	(406,492)	5,380	(686,486)
FINANCING			
Issuance of shares (net of expenses)	**943,734**	150,000	1,939,755
Deferred financing costs	**60,000**	(60,000)	–
Issuance of warrants, net of expenses	**–**	–	2,012,830
	1,003,734	90,000	3,952,585
NET (DECREASE) INCREASE IN CASH	**(139,102)**	150,011	22,208
CASH, BEGINNING OF YEAR	**161,310**	11,299	–
CASH, END OF YEAR	**22,208**	161,310	22,208

Notes to the Financial Statements

Years Ended September 30, 2004 and 2003

1. **BASIS OF PRESENTATION AND GOING CONCERN ASSUMPTION**

These financial statements have been prepared using the going concern assumption, which contemplates that PsiNaptic Inc. (the "Company") will be able to realize its assets and discharge its liabilities in the normal course of business. At September 30, 2004, there are certain aspects of the Company's financial position, which may cast doubt on the use of the going concern assumption, including a deficit of $3,593,095 and a net loss of $774,877 for the year ended September 30, 2004.

The ability of the Company to continue as a going concern is dependant upon achieving profitable operations and obtaining additional financing to develop, market and manufacture its products and services. If the Company does not achieve profitable operations or obtain additional financing, the use of the going concern assumption may not be appropriate.

Management expects the cash balance will be fully utilized in February 2005 and is presently pursuing additional public and private sources of financing. In addition, management is reviewing measures to reduce its cash expenditures. Although licensing agreements in place provide for certain minimum licensing revenue in 2005, these revenues will be insufficient to maintain the present level of operating expenditures.

If the going concern assumption is not appropriate, then adjustments may be necessary to the carrying values of the assets and liabilities, the reported net loss and the balance sheet classifications used, and these adjustments may be material.

2. **NATURE OF OPERATIONS**

The Company was incorporated on December 16, 1999 under the Business Corporations Act (Alberta) as 858393 Alberta Inc. On January 6, 2000, the Company changed its name to PsiNaptic Communications Inc. On May 1, 2001, the Company changed its name to PsiNaptic Inc. To date, the Company has not earned significant revenues and is considered to be in the development stage. The Company's focus has been research and development of novel, deeply embedded wireless Java modules. These devices are intended for use in wireless distributed computing environments and are targeted for sale to original equipment manufacturers.

Project under development

The project currently under development is a very small, low-cost, low-power hardware module that combines Bluetooth wireless technology and a Java computing engine. To date, all amounts incurred to develop this project have been expensed.

3. **CHANGE IN ACCOUNTING POLICIES**

On October 1, 2003, the Company adopted the new accounting standards for impairment of long-lived assets, which establishes the standards for recognition, measurement and disclosure of the impairment of long-lived assets. The standards require that long-lived assets be tested for recoverability whenever events or circumstances indicate that carrying value may not be recoverable. No impairment loss has been recognized in the statement of loss for the year ended September 30, 2004.

On October 1, 2003, the Company elected to prospectively adopt the fair value based method of accounting for options granted subsequent to October 1, 2003 under its stock-based compensation plan as recommended by the Canadian Institute of Chartered Accountants ("CICA"). Compensation expense of $359 has been recognized in the statement of loss for the year ended September 30, 2004 using the fair value based method as described in Note 7. Previously, the Company accounted for its stock-based compensation plan using the intrinsic value based method and accordingly, did not recognize compensation expense in the financial statements for share options granted to employees and directors when issued at market value.

The Company's stock-based compensation plan is described in Note 7.

4. SIGNIFICANT ACCOUNTING POLICIES

Cash

Cash includes cash on hand, balances with banks and short-term deposits.

Short-term investments

Short-term investments are valued at the lower of cost and market value.

Deferred financing costs

Deferred financing costs represent costs related to the initial public offering (Note 7) and were recorded as a reduction of the proceeds from the initial public offering upon completion of the transaction.

Capital assets

Capital assets are recorded at cost and are depreciated over their useful lives, from the month of acquisition, using the declining-balance method at the following annual rates:

Office furniture	20%
Tools and equipment	30%
Computer hardware	30%
Computer software	30% - 100%
Development tools	100%

Intellectual property

Intellectual property consists of patents and trademarks, which are recorded at cost and amortized on a straight-line basis over their useful lives, from the month of acquisition. The estimated useful life of the intellectual property is four years.

Research and development costs

Research costs are expensed as incurred. The costs of developing new products are capitalized as deferred development costs if they meet the Canadian Institute of Chartered Accountant's development capitalization criteria related to technical, financial and market feasibility. To date, all of the development costs have been expensed as all of the criteria for deferral has not yet been met.

Scientific research and experimental development investment tax credits (SRED)

Scientific research and experimental development investment tax credits are accounted for using the income approach and are recorded upon receipt of the credit. Credits are recorded as either a reduction of the cost of applicable assets or included in income depending on the nature of the expenditures, which gave rise to the credits. With the completion of its initial public offering (Note 7) the Company continues to qualify for SRED credits to apply against future taxes payable; however, the credits are no longer refundable.

Revenue recognition

The Company recognizes revenue when an executed licensing agreement with the customer has been signed, the software product has been delivered, the amount of the fees to be paid by the customer is fixed and determinable, and collection of these fees is deemed probable. If the fee is not fixed or determinable, revenue is recognized as the payments become due from the customer. If collectability is not considered probable, revenue is recognized when the fee is collected.

The Company enters into software licensing agreements that provide for future royalty/license payments to be made based on a per unit fee. These arrangements often specify a quarterly minimum payment. Revenue from the minimum payments is recognized on a straight-line basis. Revenue associated with unit fees in excess of any minimum payments is recognized when the amount becomes determinable, generally on a quarterly basis.

Future income taxes

Income taxes are accounted for by the liability method of income tax allocation. Under this method, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and measured using the substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Incentive stock option plan

The Company has an incentive stock option plan as described in Note 7, which is administered by the Board of Directors and accounted for using intrinsic values, as defined by the Canadian Institute of Chartered Accountants ("CICA"). Effective October 1, 2003, the Company has adopted the fair value based method to account for its stock-based compensation plan. The fair value method establishes the standards of recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services provided by employees and non-employees. No restatement of prior periods was required as a result of the adoption of the new standard. Any consideration paid on exercise of stock options or purchase of stock is credited to share capital.

Financial instruments

The Company's financial instruments consist of accounts receivable and accounts payable and accrued liabilities. As at September 30, 2004, there are no material differences between the carrying values of these amounts and their fair market values due to the short-term nature of these financial instruments.

5. CAPITAL ASSETS

			2004
	Cost	Accumulated Depreciation	**Net Book Value**
Office furniture	$ 17,953	$ 9,355	**$ 8,598**
Tools and equipment	52,021	36,720	**15,301**
Computer hardware	33,247	21,497	**11,750**
Computer software	11,667	9,448	**2,219**
Development tools	99,791	99,791	**–**
	214,679	176,811	**37,868**

5. **CAPITAL ASSETS (continued)**

			2003
	Cost	Accumulated Depreciation	Net Book Value
Office furniture	$ 17,953	$ 7,206	$ 10,747
Tools and equipment	52,021	30,162	21,859
Computer hardware	29,399	17,647	11,752
Computer software	11,017	8,640	2,377
Development tools	99,791	99,071	720
	210,181	162,726	47,455

6. **INTELLECTUAL PROPERTY**

			2004
	Cost	Accumulated Amortization	**Net Book Value**
Patents and trademarks	$ 56,678	$ 36,326	**$ 20,352**

			2003
	Cost	Accumulated Amortization	Net Book Value
Patents and trademarks	$ 69,813	$ 34,268	$ 35,545

Amortization of $18,519 (2003 - $17,335) on the patents and trademarks is included in depreciation and amortization expense.

7. SHARE CAPITAL

	Number of Shares	Amount
Authorized		
Unlimited number of Class A common voting shares		
Unlimited number of Class B common non-voting shares		
Unlimited number of Special Warrants, issuable in series		
Issued		
Common shares		
Class A common shares		
Balance, September 30, 2002	12,049,809	**$ 846,021**
Private placement at $0.25 per share	600,000	**150,000**
Shares issued to consultant for marketing services, valued at $0.25 per share	400,000	**100,000**
Balance, September 30, 2003	13,049,809	**1,096,021**
Private placement at $0.25 per share	200,000	**50,000**
Initial public offering at $0.25 per share	5,000,000	**1,250,000**
Conversion of special warrants	3,657,003	**2,012,830**
Reduction in shares held by founders	(3,000,000)	**–**
Less financing costs	–	**(445,016)**
Balance, September 30, 2004	18,906,812	**3,963,835**
Special Warrants		
Balance, September 30, 2002 and 2003	–	**2,012,830**
Conversion upon closing initial public offering	–	**(2,012,830)**
Balance, September 30, 2004	–	**–**
Contributed surplus, September 30, 2004	–	**89,109**
Total, September 30, 2003	13,049,809	**3,108,851**
Total, September 30, 2004	18,906,812	**4,052,944**

Private placement units

On September 25, 2003, the Company closed the sale of 600,000 private placement units at a value of $0.25 per unit. Each private placement unit consists of one Class A common share and one common share purchase warrant, each warrant entitling the holder thereof to acquire one common share at an exercise price of $0.35 per share for a period ending on the date that is two years from the date of issuance. No amount has been allocated to the share purchase warrants.

Stock options

On September 22, 2003, the Company cancelled the existing stock option plan and adopted a new stock option plan for directors, officers, employees and consultants who help achieve the long-term objectives of the Company. The Board of Directors administers the plan. Under this plan, the directors can specify the exercise price and vesting terms on an individual basis. Options granted under this plan cannot expire more than five years after being granted.

7. SHARE CAPITAL (continued)

The total number of options outstanding under this plan cannot exceed 10% of the issued and outstanding common shares. The Company set aside a reserve of 1,704,000 common shares and has granted options to purchase 1,498,500 common shares at an average price of $0.37. In the event of resignation, retirement or termination, the optionee has 30 days to exercise the options.

Details of options outstanding under the plan are as follows:

	2004			
Expiry	**Number of Options**	**Exercise Price**	**Weighted Average Contractual Life (Years)**	**Number Exercisable**
June 30, 2005	**80,000**	**$ 0.625**	**0.75**	**80,000**
September 12, 2005	**53,000**	**$ 0.50**	**0.95**	**53,000**
March 31, 2007	**261,000**	**$ 0.75**	**2.50**	**261,000**
September 15, 2008	**1,054,500**	**$ 0.25**	**3.95**	**1,054,500**
November 21, 2008	**40,000**	**$ 0.25**	**4.15**	**20,000**
January 5, 2009	**10,000**	**$ 0.37**	**4.27**	**3,333**
	1,498,500			**1,471,833**

	2004		2003	
	Number Outstanding	**Weighted Average Exercise Price**	Number Outstanding	Weighted Average Exercise Price
Outstanding, beginning of year	**1,448,500**	**$ 0.37**	654,000	$ 0.71
Granted	**50,000**	**$ 0.27**	1,448,500	$ 0.37
Exercised	–	–	–	–
Forfeited	–	–	(654,000)	$ 0.71
Outstanding, end of year	**1,498,500**	**$ 0.37**	1,448,500	$ 0.37

The Company has estimated the value of the options granted during the year using the Black-Scholes option pricing model. As the Company was privately held throughout the first quarter, the common shares did not trade and management was unable to determine the volatility of the common shares at the time the options were granted. Therefore, volatility was excluded from the determination of compensation expense. The value of the options granted during the first quarter was $0.0477 per share based on the exercise price of $0.25 per share, a risk-free interest rate of 4.25%, an expected life of five years, and no dividends paid.

Shares of the Company began to trade on the TSX Venture Exchange on January 28, 2004. The value of options granted during the second quarter was $0.3355 per share based on the exercise price of $0.37 per share, a risk free interest rate of 2.862%, an expected life of five years, no dividends paid, and a volatility rate of 1.47. Based on the assumptions above, the Company recorded $359 on account of stock-based incentive expense for the year.

8. GOVERNMENT ASSISTANCE

In July 2003, the Company applied for and received the Industrial Research Assistance Program ("IRAP") grant from the Canadian Research Council. During the fiscal year, the Company qualified for $58,397 (2003 - $15,300), which was recognized as a deduction from aggregate expenses. The project was completed in July 2004. The grant is a subsidization of expenses incurred for the development of technical innovation in Canada.

9. COMMITMENTS

The Company has entered into a lease agreement for office space and contracted for marketing research services. The aggregate rental payments, excluding operating costs, and services payments required are as follows:

	$
2005	**46,410**

10. INCOME TAXES

The Company has accumulated the following tax balances, the future benefit of which has not been reflected in these financial statements.

Non-capital losses of approximately $2,932,000 (2003 - $2,137,000) available for carryforward expire as follows:

	$
2006	**131,000**
2007	**847,000**
2008	**865,000**
2009	**294,000**
2010	**795,000**

Investment tax credits of approximately $53,000 (2003 - $35,000) are available for carryforward and expire between 2011 and 2014.

Unclaimed scientific research and experimental development expenditures of approximately $672,000 (2003 - $648,000) carry forward indefinitely.

The Company has made a claim for refundable scientific research and experimental development tax credits in the amount of $18,124 (2003 - $11,549) which will be available to apply against future taxes payable once approved.

11. PER SHARE AMOUNTS

Loss per share has been calculated using the weighted average number of Class A common shares outstanding during the year of 17,166,964 (2003 - 12,069,535).

Diluted loss per share is not disclosed in these financial statements as the exercise of the stock options is anti-dilutive.

Corporate Information

BOARD OF DIRECTORS

Aaron Dagan*
President & CEO
PsiNaptic Inc.

Dr. Michel Fattouche*
Chief Technical Officer
Cell-Loc Location Technologies Inc.

Stuart M. Olley*
Partner,
Stikeman Elliott LLP

Andrew L. Oppenheim
Partner,
Gowling Lafleur Henderson LLP

MANAGEMENT TEAM

Aaron Dagan
President & CEO

Cameron Roe
Vice President and
Chief Software Architect

Serge Brache
Manager Engineering

Morris Bleviss
Chief Financial Officer

* member of Audit Committee

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Trading Symbol: PST

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